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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1940.

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**No. 974**

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THE UNITED STATES OF AMERICA,

*Petitioner,*

vs.

JAMES M. RAGEN, SR.,

*Respondent.*

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ANSWER OF RESPONDENT, JAMES M. RAGEN, SR.,  
TO PETITION FOR WRIT OF CERTIORARI.

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OPINIONS BELOW

The opinions of the United States Circuit Court of Appeals for the Seventh Circuit are reported in *U. S. v. Molasky*, 118 F. (2d) 128.

## QUESTIONS PRESENTED

The Government's contention is that the principal question presented is whether there is a sufficiently definite standard of guilt for the jury to convict if any services at all were rendered. This is contrary to its theory of the case in both the courts below wherein the Government took the position that the question was irrelevant and had no application to the case under the pleadings and the proof. The government so argued in the Circuit Court of Appeals and that court accepted and acted upon that theory.

But if the question whether there is a sufficiently definite standard of guilt for the jury to convict in such a case, may now be raised for the first time by the Government, that question should be answered in the negative.

As we view the case, the principal question involved is the sufficiency of the evidence to support the verdict. If that question should be decided adversely to respondents,<sup>1</sup> there also arise for consideration the questions as to whether (a) there was a failure to prove the charge alleged in the indictment causing a fatal variance between the indictment, the Government's theory of the case and the proof; and (b) whether the jury was properly instructed. These were the questions which were argued by the Government in the trial court and in the Circuit Court of Appeals, not the question now urged for the first time as ground for certiorari.

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<sup>1</sup> "Respondents" throughout this Answer is used to refer to James M. Ragen, Sr., Arnold W. Kruse and Lester A. Kruse, the respondents to the Petition for Writs of Certiorari in cases Nos. 974-976. "Defendants" is used to refer to all the individual defendants convicted in the trial court and includes in addition to the respondents, William Molasky and James M. Ragen, Jr., as to whom Petitioner does not seek writs of certiorari.

It is recognized on page 2 of the petition that the last mentioned questions (a) and (b) may be presented by the decision below. In view of the circumstance that they were decided adversely to the Government by the Circuit Court of Appeals, necessarily they are in the case before this court. The question of whether the statute contains a sufficiently definite standard of guilt for the jury to convict if any services at all were rendered, becomes an important question only in the event that it is decided that the evidence was sufficient to support a verdict of guilty, that the jury was properly instructed, and that there was not a failure on the part of the Government to prove the charge alleged in the indictment and the essential facts to support the theory upon which it tried the case and urged conviction in the Courts below.

The question as to whether the statute contains a sufficiently definite standard of guilt was urged by respondents in the Circuit Court of Appeals, but was met by the Government with the contention that it is immaterial whether or not services were rendered, that the sole question is whether profits were distributed as dividends to stockholders, regardless of whether the stockholders rendered services to Consensus for which they might have been paid. The Government throughout has contended that the amounts in question were dividends in their entirety and therefore not deductible, as distinguished from commissions which were deductible. (See opinion of Circuit Court of Appeals, R. 501, 502.)

## STATEMENT

The record is voluminous. The evidence, however, was not conflicting. It consisted only of testimony of witnesses called by the Government, one of whom was examined as a court witness, and the exhibits introduced by the Government. The defendants offered no evidence.

The Government's statement is too abbreviated to present a fair picture of the case. A statement of facts sufficiently complete for the purposes of this answer may be found in the opinion of the Circuit Court of Appeals (R. 485), to which we refer without attempting to restate it.

We remark that both the District Court (R. 463) and the Circuit Court of Appeals (R. 500, 503) concluded that the evidence disclosed that respondents in fact had performed services and were entitled to compensation therefor.

## REASONS FOR NOT GRANTING CERTIORARI

1. **The question as to whether the statute contains a sufficiently definite standard of guilt relied upon as the reason for certiorari was not urged by the Government in either of the lower courts. It is raised in this court by it for the first time, notwithstanding that under the theory of the case as it was presented by the Government in both courts below that question was immaterial and irrelevant.**

The indictment consists of five counts (R. 2-27). The first four counts charged an attempt to evade taxes of the Consensus Company for the respective years, 1933 to 1936. The taxes which the defendants were charged with having sought to evade were taxes payable only if the deduction for commissions paid to the defendants was disallowed in its entirety and if nothing was due to them

for their services rendered to Consensus. None of these counts contains any direct allegation charging that the deduction for commissions was illegal or why such deduction could not be taken.

The conspiracy count covered all the years 1929 to 1936 and alleged as the sole ground of illegality of the deductions for commissions that the defendants were not employees of Consensus and rendered no services to it, but were, owners of beneficial interest therein and that these sums, in fact, were paid to them as distributions of profits or dividends.

That these commissions were all distributions of profits or dividends to stockholders of Consensus, as distinguished from being in whole or in part compensation for services rendered to it, has been the theme of the Government's case throughout. It was so understood by the Circuit Court of Appeals. That Court said:

"Under the Government's theory, however, it is immaterial and irrelevant as to whether the defendants performed services for which they might have been entitled to compensation or salary. The case was tried and is presented here on that theory. In other words, the Government argues that conceding the defendants rendered services for which they might have been entitled to compensation, yet the disbursements were received as corporation dividends and were, therefore, unlawful deductions." (R. 501)

In fact, this same view is reasserted in footnote 9 on page 15 of the petition. The circumstance that no effort was made by the Government to prove all of the services rendered by the defendants to Consensus and that no testimony was introduced on the subject of the value of their services emphasizes this view.

Faced with the uncontradicted proof that the defendants, in fact, had rendered services for which in the opin-



ion of the trial court and in the opinion of the Circuit Court of Appeals they were entitled to compensation (and which under the statute would be a deductible item to the extent that the amounts paid were reasonable), the government now changes its theory and urges that the case involves a question as to whether respondents may be convicted if the amounts in question represented in part compensation paid for services which was deductible if the remaining portion thereof was not, for the reason that the government is not required to prove an evasion of all the tax charged, but only of a substantial part. And this is done notwithstanding no attempt was made by the government upon the trial to show all of the services performed for Consensus by the defendants or the value of their services.

In the Circuit Court of Appeals the Government in its brief urged:

"First the defendants contend that the alleged commissions representing the distributions of seventy per cent of the company's net profits were deductible expense and they cite the section of the revenue acts which allows deductions for necessary and proper expenses. It is submitted that (1) the question here is not one of the deductibility of commissions paid out by a corporation in the operation of its business but whether these payments of net earnings were 'commissions'." (p. 75)

"On the basis of the foregoing, it is respectfully submitted that there is no issue involved in this case regarding the question of whether commissions may be deducted or whether the payments were reasonable. We cannot repeat too often that there are no questions concerning commissions, because these payments were dividends and were known to be such by the defendants. Likewise it is wholly irrelevant to discuss the question of whether it would be a violation of the Fifth and Sixth Amendments if individuals

were convicted of a crime of deducting unreasonable commissions." (pp. 82, 83)

The same theory was also advanced by the Government in the trial court. (See argument on motion for a directed verdict. R. 459)

The question arising under the Fifth and Sixth Amendments to the Constitution stated in the last mentioned excerpt from the brief as being wholly irrelevant is the question now presented as the ground for *certiorari*. But the Government refused to discuss that question in the Circuit Court of Appeals, ignored the case of *United States v. Cohen Grocery Company*, 255 U. S. 81, and cases of similar import, which had been cited by respondents, and did not refer to or cite any of the other cases mentioned in its petition, nor make the distinction now sought to be made on pages 11 and 12 of its petition between *United States v. Cohen Grocery Company*, 255 U. S. 81, and *Gorin v. United States*, 85 Law. Ed. (Adv. Op.) 356, but was content to rest its case upon the contention that the question was an immaterial one.

If it was intended by the Government to raise a question as to whether respondents could be convicted if only a portion of the commissions were not deductible, on the theory that such commissions were in excess of reasonable compensation for services rendered, it would have been essential for the Government to prove all the services rendered by the defendants for the Consensus Company and the reasonable value thereof. But, as stated by the Circuit Court of Appeals: "There was no proof and no effort by the Government to show that the services disclosed constituted the total of those performed and no effort to show the reasonable value of such services." (R. 500)

The argument of the Government in the Circuit Court of Appeals is thus stated in the opinion below (R. 502):

"The Government in its brief and in oral argument before this Court asserts that the deductions in question must be treated either as dividends in their entirety, and if so as unlawful deductions, or as commissions in their entirety, and therefore properly deducted. In other words, in accordance with this argument there can be no middle ground. We agree with this argument for two reasons: *First, it was directly alleged in the conspiracy count of the indictment and impliedly in the other counts that none of the defendants 'rendered any services to the said corporation.'* Thus the question was directly in issue and the Government had the burden of establishing the affirmative. *Second, it is a serious question whether a prosecution for income tax evasion, founded upon improper deductions, can succeed where the proof is other than that the deductions are improper in their entirety.*" (Italics supplied.)

It will be noted from the foregoing that the case was tried on the theory that none of the defendants to the indictment had rendered services, or, if they had, that that circumstance was immaterial. The second question which the Court suggested in the foregoing quotation from its opinion, was completely ignored by the Government, which was content to rest its whole case upon its argument of the immateriality of the rendition of services to Consensus by the defendants.

We submit that the Government has no right to change its theory from that directly alleged in the fifth count of the indictment, implied in the remaining counts, and upon which the case was tried by it in both the courts below, in favor of a new theory first advanced by it in this court, which it emphatically rejected as a question in the case in the lower Courts and which is unsupported by evidence introduced in the trial court on the subject of

the total of the services performed by the defendants or the value of those services.

If the Government was of the opinion that a decision based upon the *Cohen* case would have had any effect upon the enforcement of the revenue laws, that argument could have been made to the Circuit Court of Appeals. The Government chose not to do so.

## **2. The application of the Fifth and Sixth Amendments of the Federal Constitution to the case.**

While the prosecution was under Section 145(b) of the Revenue Act for willfully attempting to evade income taxes, and Section 88, Title 18 U.S.C.A. for conspiracy to defeat and evade income taxes, the question as to whether any tax was attempted to be evaded is dependent upon Section 23(a) of the Revenue Act, providing that in computing net income there shall be allowed as deductions "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered."

Under the due process provision of the Fifth Amendment and the provision of the Sixth Amendment that the accused shall enjoy the right to be informed of the nature of the accusation against him, all crimes are required to be specifically defined, so that one may know in advance whether an act is within or without the prohibitions of the law. The question of guilt or innocence cannot be left to the whims or fancies of triers of the fact, without definite, ascertainable standards to guide them in their determination. Leaving to the triers of the fact the question of guilt or innocence, depending upon their determination of the reasonableness or unreasonableness of the amount

paid as compensation for services, is contrary to the provisions of the Fifth and Sixth Amendments. *U. S. v. Cohen Grocery Co.*, 255 U. S. 81, 98; *Connally v. General Construction Company*, 269 U. S. 385, 391; *International Harvester Co. v. Kentucky*, 234 U. S. 216, 221.

The Treasury Regulations on the subject of deductibility of items paid for services<sup>3</sup> are no more adequate than the statute in fixing a standard.

The petition seeks to make a distinction between *United States v. Cohen Grocery Co.*, 255 U. S. 81, and this case, on the basis that the statute here involved requires that there be a *willful* attempt at tax evasion (Pet. 11-12). But the statute involved in the *Cohen Grocery Co.* case also required the prohibited action to be willful. That statute made it a criminal offense "wilfully \* \* \* to make any unjust or unreasonable rate or charge in handling or dealing in or with any necessities", 255 U. S. 85. The statute there involved was held unconstitutional.

In the *Gorin* case, principally relied upon by the Government, *United States v. Cohen Grocery Co.* was referred to with apparent approval. The two cases (*United States v. Cohen Grocery Co.* and *Gorin v. United States*) are but two of the many cases decided by this Court determining on which side of the line falls a statute, the constitutionality of which is challenged on the ground that it does not provide a sufficiently definite standard of guilt.

In Note 12 of the *Gorin* case (85 L. Ed. Adv. Op. 361) several references are made to criminal statutes which were held to be too vague, and consequently falling on one side of the line, and in Note 13 on the same page ref-

<sup>3</sup> These are set forth in the Appendix to this Answer. The excerpts from the Treasury Regulations copied in the Appendix to the Petition do not give all the pertinent provisions on this subject.

ferences are made to other criminal statutes held to adequately define the crimes, and consequently falling on the other side of the line. We submit that the statute in this case, if construed as the Government seeks to have it construed, is within the former category, and that it is closer to the statute held unconstitutional in *United States v. Cohen Grocery Co.* than the statute involved in any of the other cases cited.

The Government stresses the necessity of the element of wilfulness in order that there be a successful prosecution under Section 145(b). But there must also be tax evasion. In a case such as this, whether there is tax evasion depends upon the judgment of the triers of the fact as to the reasonableness of the compensation paid, without any standard laid down by the statute for determining that question.

The sufficiency of the statutes here in question to define an adequate standard of guilt was not raised or discussed in *United States v. Kelly*, 105 F. (2d) 912. Several of the items for which deductions were taken in that case were fabricated. *U. S. v. Zimmerman*, 108 F. (2d) 370, does not pass upon any such question. There is, therefore, no conflict between decisions of Circuit Courts of Appeal on this subject.

The question here is not whether the Government is required to prove an evasion of all the tax charged, but whether it must prove an actual evasion of some part of the tax, the determination of which can be made by reference to a standard sufficiently definite to meet constitutional requirements.

Regardless of the question as to whether the statutes here involved contain a sufficiently adequate standard of guilt, we submit that the Circuit Court of Appeals was right in reversing the judgment, because a verdict for

respondents should have been directed and because of error in instructing the jury. These questions will be briefly discussed below.

### **3. A verdict for respondents should have been directed.**

The Government indicates in its petition that the Circuit Court of Appeals reversed "because it did not think the evidence sufficient to support the verdict" (Pet. 10). That is our view. The trial judge also indicated he would have directed a verdict for respondents if the Government had the right of appeal. (R. 464-466)

The Circuit Court of Appeals in its opinion said it is "our conviction derived from a study of the record that the Government's case is not strongly supported. In fact we agree with the District Judge when he said in denying the motions for directed verdict: 'I admit that I think this is a pretty weak case.' " (R. 499)

Whether a verdict should have been directed for respondents or not requires a review of the evidence and the inferences to be drawn therefrom. In *General Talking Pictures Co. v. Western Electric Co.*, 304 U. S. 175, 178, it was said that the "Granting of the writ would not be warranted merely to review the evidence or the inferences drawn from it."

The Circuit Court of Appeals from the undisputed evidence concluded that although there was evidence to support the Government's contention that respondents were owners of stock of Consensus, the undisputed evidence also showed the following facts: (a) the respondents rendered services to Consensus (R. 500, 503); (b) there was evidence of an express agreement that they were to be compensated on the commission basis actually used to pay them for such services (R. 500); (c) regardless of whether that agreement was made or not the law

would imply an agreement to pay them reasonable compensation (R. 500); (d) the Government did not attempt to prove the total of the services rendered by them or the value of their services (R. 500); (e) that the indictment was based and the case was tried upon the theory that respondents rendered no services to Consensus. (R. 500, 592) Such being the case, we submit a verdict should properly have been directed for respondents.

#### **4. Error in instructing the jury.**

The portion of the charge objected to by respondents is set forth on pages 8 and 9 of the petition. There was no conflict in the evidence as to the profits of Consensus before paying commissions to the defendants nor regarding the amount of commissions so paid. If the Government's theory of the case, that it is immaterial whether the defendants rendered services or not, is sound, there was no occasion for such a charge as that excepted to.

There was no proof in the case from which the jury could determine the reasonable value of the defendants' services. We submit the excepted portion of the charge only could be construed by the jury as authorizing them to determine whether any portion of the sums paid to the defendants as commissions represented a distribution of profits, because in the opinion of the jury the amounts paid were unreasonably large as compensation for the services shown to have been rendered, and this without evidence upon which the jury could come to a conclusion upon that subject.

The observations in the footnote on page 11 of the petition, that the jury might have found that in some years one or more of the defendants rendered no services, or that as to some of the defendants some or all of the payments were profits in their entirety, is unsupported by



any evidence upon these questions upon which the jury could have made a finding. Consequently, any verdict of the jury upon any such issue would have been one based upon conjecture and surmise, not evidence.

### CONCLUSION.

It is respectfully submitted that the petition should be denied.

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MATTHIAS CONCANNON,

SIDNEY R. ZATZ,

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## APPENDIX.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 126. *Compensation for personal services.* Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. \* \* \*

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though

in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

ART. 127. *Treatment of excessive compensation.*—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend, and will thus be exempt from the normal tax in the hands of the recipient. \* \* \*

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Article 23(a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted, except that in sub-section 3 the words "under all the circumstances" are used instead of the words "in all the circumstances" and the words "under like circumstances" are used instead of the words "in like circumstances".

Article 23(a)-7 is identical with Article 127 of Treasury Regulations 77 above quoted.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 23(a)-6 is identical with Article 23(a)-6 of Treasury Regulations 86.

Article 23(a)-7 is identical with Article 127 of Treasury Regulations 77 above quoted, except for the omission from Article 23(a)-7 of Regulations 94 of the following phrase from the end of the second sentence: "and will thus be exempt from the normal tax in the hands of the recipient."

